Abusive Tax Shelters: What they look like and how to find them

Debbie Petersen

California Franchise Tax Board

Definition – Abusive Tax Scheme

- Generally, an abusive tax scheme is a transaction that:
  - is promoted with the promise of tax benefits
  - has predictable tax losses or tax consequences
  - has no true or correlating economic loss experienced with respect to the taxpayer's income or assets

Definition – Abusive Tax Scheme

- Generally, an abusive tax scheme follows the literal reading of the tax statute, but applies the meaning in a manner that is inconsistent with the purpose or intent of the tax statute

Characteristics – Abusive Tax Schemes

- Separation of income and expenses
- Use of pass-through entities
- Use of third-party accommodators
- Offshore foreign account or accommodator
- Double benefit for the same tax loss
- Conducted over a short period of time

Definition – Economic Substance

- Court decisions require that a transaction have:
  - economic advantages other than the tax savings
  - balanced economic risks and profit potential when compared to the tax benefits
  - a business purpose separate from the tax consequences

Definition – Business Purpose

- A transaction has a business purpose if it is engaged in for a justifiable business reason other than reducing taxes and has a potential for generating a profit

Investor Profile

- large, constant streams of income
- substantial gains from one-time event
- income from criminal or illegal activities
- engaged in shelter activity in the past

Common Tax Shelters

- Basis Shifting
- Charitable Remainder Trust
- Corp Owned Life Insurance (COLI)
- Lease In/Lease Out
- Lease Stripping
- Notional Principal Contract
- Inflated Basis (Son of BOSS)
  - Contingent Liability
  - Custom Adj Rate Debt
  - Digital Options
  - Loan Assumptions
  - Loan Premium
  - Short Sales
- Real Estate Invest Trust
- Regulated Invest Co.

Shelter Fingerprints

- Schedules D and E activity
- Large short-term capital or ordinary loss
- Large gains from sale but low AGI
- Newly formed/recently dissolved entities
- Significant tax & book income difference
- Issuance of new class of stock
- Large cash outlay for fees
- Tax indifferent entities involved

Looking for Hidden Transactions

- Tiering
- Netting

Reporting Requirements

- Taxpayer return disclosure
- Promoter registration requirements
- Promoter maintains/provides list of investors

Current Information Sources:

- Computer based selections & modeling
- PASS System
- Informants leads
- IRS MOU leads
- States leads
- Taxpayer amended returns (VCI)
- Audit leads

New Information Sources:

- Tax Shelter Registration statements
- List of Investors
- Return Disclosure statements
- Tax Shelter IDRs
- MOA with States
- Promoter Audits
- Joint Audits
- Subpoenas
- New M-3/Accrual WPs

Son of BOSS Transactions

- IRS Notice 200-44
  - Loan Premium (BLIPS)
  - Digital Options (COBRA)
- Substantially similar
  - Short Sales
- Inflated Basis – Contingent Liability

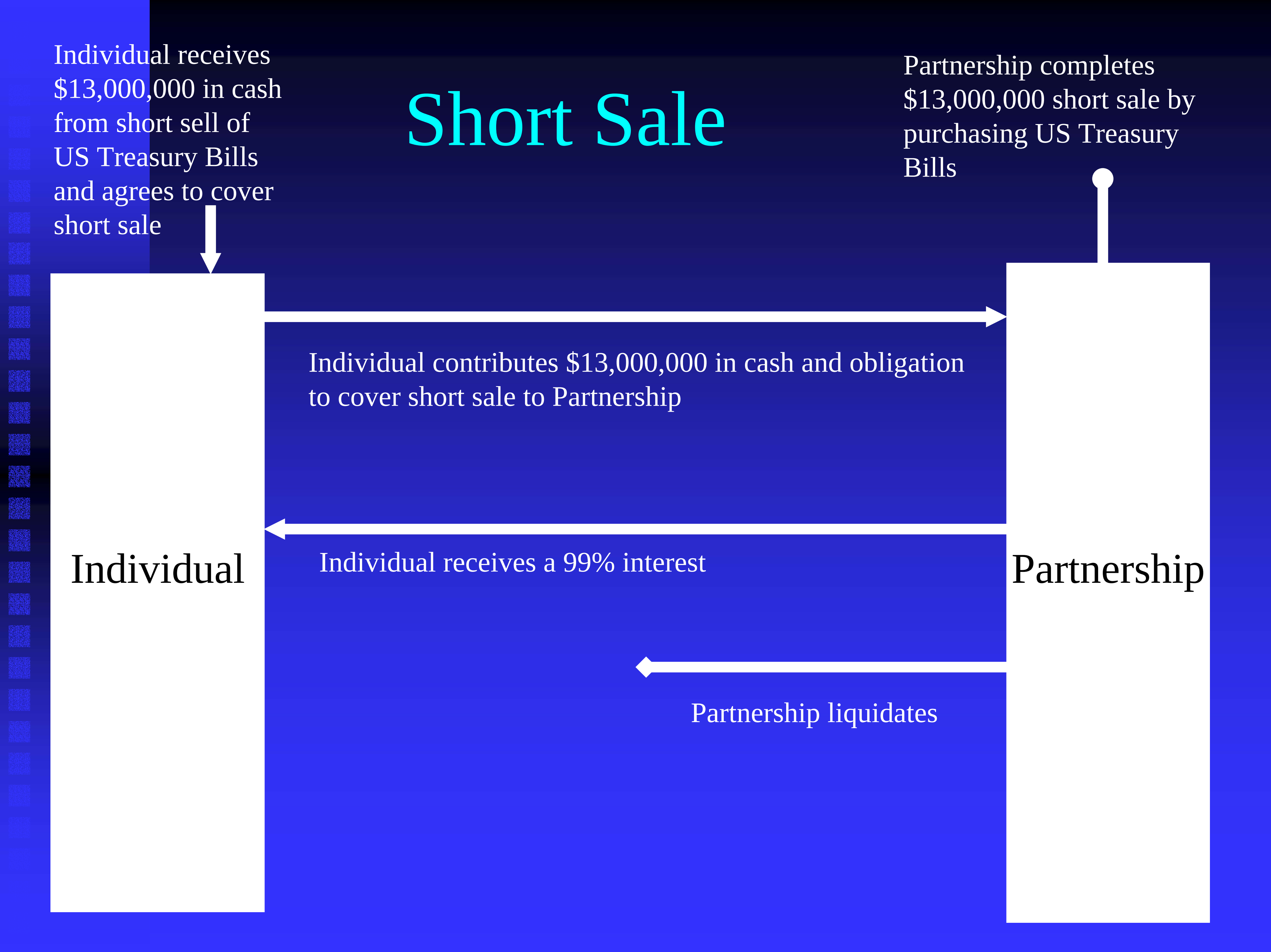
Example: Short Sale

- Economy is slow. Stock market is declining. You still want to make a profit
- ABC Corp. is trading at $50 a share today
- You call your broker and tell them to sell 100 shares that you do not own (short sale)
- 60 days later, ABC Corp. is trading at $40 a share
- You call your broker and tell them to purchase 100 shares and close the sale
- You made a profit of $1,000 even though the market was declining

Tax Shelter Short Sale

Taxpayer has $15,000,000 in capital gain income in 2002.

Taxpayer wishes to reduce his tax liability resulting from the capital gain and invests in a short sale transaction as follows:


Short Sale
Individual receives $13,000,000 in cash from short sell of US Treasury Bills and agrees to cover short sale
Partnership completes $13,000,000 short sale by purchasing US Treasury Bills
Individual
Partnership
Individual contributes $13,000,000 in cash and obligation to cover short sale to Partnership
Individual receives a 99% interest
Partnership liquidates

Short Sale

	Taxpayer's Position	Government's Position
Basis Calculation of Partnership Interest		
Contribution of Cash	$13,000,000	$13,000,000
Less: Liabilities assumed by Partnership	(0)[A]	(13,000,000)
Partnership Basis	$13,000,000	$0
Total Loss	$13,000,000[B]	$0

[A] Individual argues liability is contingent, thus, does not reduce basis

[B] Individual offsets capital gain income

Short Sale

Discussion Points

1. ***Economic consequences*** - Taxpayer has generated a huge tax loss without incurring any actual monetary loss. Taxpayer originally received $13,000,000 in cash for the sell of Treasury bills and was required to purchase $13,000,000 in treasury bills to close the short sale. Net $0.

Short Sale

2. ***Taxpayer's risk*** - The potential for loss was negligible considering the assets, U S Treasury bills used to conduct the transaction and the length of time this series of transactions usually take – less than 1 month.
3. ***Substance over form*** - Without the partnership entity, the taxpayer could not have generated such a loss.
4. ***Business purpose*** - Except for the tax benefits of $3.1M, no potential for a profit comparable to the tax benefits existed.